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No. 88-385

In The

Supreme Court of the United States

October Term, 1988

OFELIA RODRIGUEZ de QUIJAS, ET AL,

Petitioners,

vs.

SHEARSON/AMERICAN EXPRESS, INC. ITS SUCCESSORS AND ASSIGNS,

Respondents.

REPLY BRIEF OF PETITIONERS

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March 17, 1989

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QUESTIONS PRESENTED

1. Are claims under Section 12(2) of the 1933 Securities Act now arbitrable under predispute broker contracts?

2. If such claims are now arbitrable, may these Petitioners be compelled to submit such claims to arbitration pursuant to terms of a predispute contract executed at a time when Section 12(2) claims were clearly not subject to arbitration?

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ARGUMENT

1. As Determined By This Court In *Wilko*, The Intent Of The 1933 Securities Act Was To Void All Compulsory Predispute Arbitration Agreements Concerning Section 12(2) Public Customer Complaints

Neither the intent of the 73rd Congress nor the views of the seven justices of the *Wilko* Court[1] can be changed,

[1] See, L. Loss, *Fundamentals of Securities Regulation*, (1983) at 1193, where Professor Loss noted that *Wilko* " . . . presented a neat conflict between two socially desirable policies – arbitration with its advantages of speed and economy, and protection of the rights of investors against persons with superior bargaining power." The determination made by the *Wilko* court to negate arbitration was, according to Loss, "eminently sensible". Id. at 1193

both of which acts Respondent would attribute to the *McMahon* majority opinion. *McMahon* was not a Section 12(2) case and despite the language quoted by Respondent (Brief at 11-2), *McMahon*, like all cases from *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974), on forward, endorses the thesis that every federal statute must be independently examined vis a vis the question of negation of the FAA's applicability. That is, of course, precisely what Respondent argued to this Court in *McMahon*.[2]

Moreover, the *McMahon* logic is itself flawed and even advocates of arbitration in other contexts assail that decision. One such advocate, Professor Carbonneau, has, with unusual candor, very recently written of *McMahon*:

> Both the end achieved and the means employed . . . indicate that the Court will to practically any length to uphold arbitration agreements, *McMahon* makes it abundantly clear that the Court is impelled by an unbending objective: fostering the unfettered recourse to arbitration. In effect, the Court's desire to eliminate all vestiges of judicial hostility toward arbitration has given arbitration a privileged position in the cosmology of protected judicial values. Indeed, following *McMahon*, it is not all implausible that the consideration afforded arbitration is not so different, in kind or in degree, from the constitutional regard given to political speech, racial equality, or other fundamental values or rights. The uncompromising tenor of the doctrine generates questions about the wisdom and motivation for the Court's stance . . .
>
> . . . to achieve the objective of declaring that both Exchange Act and RICO claims are arbitrable, the

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[2] Brief of Petitioners On The Merits, *Shearson/American Express, Inc. v. McMahon*, No. 86-44 at 12, 14.

> Court engages in an uncharacteristic and disappointing display of narrow, strained, and distortive construction of statutes and prior decisional law. While the Court's aim of eliminating any restrictions on arbitration is transparent, its methodology and doctrine are confusing, unpersuasive, and ultimately unsound . . .
>
> The reasoning in *McMahon* suffers from several methodolical and conceptual difficulties. As to the issue of the arbitrability of Exchange Act claims . . . the majority opinion begins by incanting the now-consecrated view that a claim based upon statutorily-conferred rights does not disrupt the ordinarily "hospitable" inquiry into the question of arbitrability. To defeat the implied presumption favoring the arbitrability of claims, the statute that is the vehicle for creating the rights must contain, in either its language or its legislative history, a congressional command mandating exclusive recourse to the courts for the vindication of claims. Moreover, the burden is upon the party opposing arbitration to establish the existence of such congressional intent. Having weighted the inquiry in favor of a finding of arbitrability the majority opinion then engages in a series of strained constructions to guarantee the result implied by its initial proposition . . .
>
> . . . the Court advances a painfully technical interpretation of the Exchange Act arguing that the non-waiver language of the Act applies exclusively to the substantive obligations under the legislation. Since the recourse to arbitration merely represents the selection of a different forum and remedial process, such an agreement – the Court would have us believe – has no impact upon the substantive statutory rights in question . . .
>
> The Court, however, attributes no significance whatever either to the underlying purpose of the Exchange Act (to protect individual investors from overreaching by securities industry professionals) or

to the intractable reality that arbitrators are likely to construe the applicable law very differently from judges, especially in light of the fact that the arbitral procedure in these circumstances is established and directed by the securities industry. In effect, the Court chooses to ignore the adhesionary character of the contract and the arbitration agreement, neglecting the evident need for consumer protection generated by the facts. The Court exhibits similarly tendentious and distortive reasoning in its attempt to align the result in *McMahon* with the principles of prior decisional law on arbitration. . . .

For example, the majority opinion interprets the *Wilko* decision as barring the selection of a non-judicial forum where arbitration is inadequate to protect the substantive rights at issue. . . .

In effect, *Wilko* stands for a very different proposition . . . According to the express language of *Wilko*, as between two competing congressional policies – upholding arbitration . . . and protecting securities investors . . . the *Wilko* Court gave effect to the latter in light of the express statutory language in the 1933 Act providing for exclusive judicial remedies and relief. [footnotes omitted][3]

2. The 1933 Act Expressly Prohibits Waiver Of "Any Provision" And Not "Substantive Duties"

Respondent (Brief at 12, 14) structures its argument around what it calls "substantive duties," however, Section 14 of the 1933 Act provides, in clear, unambiguous language, that investors may not be compelled to waive

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[3] T.E. Carbonneau, *American And Other National Variations on The Theme of International Commercial Arbitration*, 18 Ga. J. of Int'l & Comp. L. 143, 224-229 (1988).

compliance with any *provision*. There is no reference to "substantive duties."[4] The entire notion of substance versus procedure, seen throughout the *McMahon* majority opinion, is textually and historically insupportable. Neither the Act itself nor any dictionary defines "provision" as "substantive duty" nor does the *Wilko* opinion admit of any such definition. As one court has noted, "As applied to legislation, the word 'provision' has this well-understood meaning: 'actual expression in language' – the clothing of legislative ideas in words which can be pointed out upon the page, and read with the eye." *State v. Lund*, 67 S.W. 572, 576 (1902).

Section 22(a) of the Securities Act implements the *in terrorem* civil provisions of the 1933 Securities Act, providing that federal and state courts shall have concurrent jurisdiction "of all suits in equity and actions at law," and providing for mandatory venue. The section further negates removal jurisdiction. If Congress had intended that Securities Act claims be arbitrated, then surely the reasonable argument to be made is that why then was *arbitration* not specifically referred to in Section 22 and *its* venue proscribed? The entire section was, after all, preceded by the heading "Jurisdiction", a term whose meaning and legal import are well appreciated in other contexts.

The legislative history of the 1933 Act clearly provides the answer. Those who breach the 1933 Act's fiduciary duties are to answer for such violations in a court of

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[4] For the view that the burden of proof of a fiduciary in a fraud action is a matter of substance, see *Vance v. Guy*, 31 S.E.2d 766 (1944) and *Fitzsimmons v. Frey*, 43 N.E.2d 531 (1950). On such view, realities of arbitration can be viewed as negating the equivalent 12(2) right.

law. A nation had finally had enough. Slippery, slick-talking salesmen and corporate carpetbaggers were at long last going to face the music in a *court of the investor's choice*. Section 14's non-waiver provisions were a clear recognition by this nation's 73rd Congress that those whose glib tongues had enabled them to sell the most outrageous investment schemes to the American public, would be expected to attempt to extract from the investing public, every right created by the 1933 Act.[5]

Respondent's adhesion contract slight of hand, which flaunted SEC Rule 15c2-2 (and effectively this Court's *Wilko* instruction) is, sadly, in the historically predatory tradition of the securuties industry. Petitioners have already purchased Respondents' false investment promises with their life savings and, apparently unlike the majority in *McMahon*, have a hardened perspective which exposes the stock of industry arbitration for what is – the last opportunity to avoid the consequences of fraudulent acts prohibited by the 1933 Act, the last opportunity, as it were, to cheat.[6]

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[5] Nor does the FAA, if one acknowledges the apparent intent of Section 2's savings clause, evidence any intent to negate the distributive justice role that courts play in American jurisprudence, which, as one author has noted, is the effect of the holding in *Mitsubishi Motors Corp. v. Soler-Chrysler Plymouth*, 473 U.S. 614 (1985) and which is the logical eqivalent of granting to private parties the right to assess and collect taxes. See Morgan, *Contract Theory and the Sources of Rights: An Approach to the Arbitrability Question*, 60 S. Cal. L. Rev. 1059 at 1081-82.

[6] See Appendix A for an insider's reve'ation of how that is accomplished in the NASD where investors have the "option" of choosing arbitrators from a hand-picked corps of individuals who have already been carefully pre-screened by the NASD on the basis of proven pro-industry bias.

3. Any SEC Role Is Not Relevant To The Arbitrability Of 1933 Act Claims

While Petitioners believe that the historical role of the SEC in preventing securities fraud has been less than exemplary, has lessened during the Reagan administration,[7] and has been typified by the non-enforcement of SEC Rule 15c2-2, there is no textual relevance to SEC oversight in the 1933 Act since the 1933 Act contains no reference to any customer arbitration proceeding, and, as held by the seven justices in *Wilko*, the intent of the 1933 Act was to invalidate predispute arbitration agreements.[8] Petitioners emphasize, again, that the problems relevant to arbitration of 1933 Act claims are inherent and intractable. Whatever alterations are ultimately mandated by the SEC, those cannot rewrite the 1933 Act (nor in Petitioners' view, could they ever provide a fair forum in which to hold those dealing with "other people's" money fully accountable).[9]

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[7] "The SEC's reversal [in *McMahon*] can be seen as an aspect of its generally deregulatory mood under President Reagan and Chairman Shad . . . " Bromberg & Lowenfels, *Securities Fraud And Commodities Fraud*, Vol. 6, NM:46.1 (1988).

[8] Petitioners further note that the SEC has not filed an amicus brief here nor requested participation in oral argument.

[9] The Brief of the Securities Industry Association in Support of Respondants, *Rodriguez v. Shearson/American Express*, No. 88-385, submits an *unaudited, three-month* study which omits "one isolated case . . . because it was considered to bias the remainder of the sample" to show (apparently) that arbitration is, in terms of comparative *result*, fair. Id. at A-22 through A-26.

4. The Legislative History Of The 1975 Amendments To The Exchange Act Which Specifically Endorse *Wilko* Together With 35 Years Of Congressional Acquiescence Cannot Be Explained Away As The Congressional Intent Of "Leaving The *Wilko* Issue To The Courts"

The *McMahon* view of the 1975 Exchange Act amendments as not constituting an endorsement of non-arbitrability of Exchange Act claims, is a strained view, and any extension of such view in an attempt to negate the 1975 Exchange Act's Amendment history as an endorsement of *Wilko*, per se, vis a vis the 1933 Act's non-arbitrability of 12(2) public customer claims, tests the limits of reasonable construction.

5. Stare Decisis Should Be Adhered To for Institutional Reasons

Apart from basic jurisprudential reasons for adhering to *Wilko*, as advanced heretobefore by Petitioners, there is an additional, significant institutional reason for preserving such precedent. Unlike the vast majority of prior decisions of this Court wherein precedents have been overruled, a destruction of *Wilko* would raise a clear self-interest suspicion since the effect of a change in *Wilko* would, in light of the judicial and extra-judicial rhetoric of this Court that arbitration will reduce the burden on the nation's court system,[10] suggests self-interest. In the

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[10] See, for example, Burger, *Isn't There A Better Way?* 68 A.B.A. J. 274-75 (1982). This self-interest suspicion is amplified where, as here, the precedent is *regulatory* in nature (parties can adjust their voluntary acts to conform to the precedent) as

(Continued on following page)

context of the federal courts, whose judges are appointed for life, that self-interest suspicion is substantial and represents a potential loss far exceeding any hoped-for administrative gain.

6. Retroactivity Of Any *Wilko* Change Would Be Manifestly Unjust

The historical record is clear: Until *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985), there was no hint that any public customer fraud case under the 1933 Act could be subjected to compulsory arbitration via a predispute agreement purporting to effect that result and retroactive application of any change to *Wilko's* view of the non-arbitrability of 1933 Act claims arising under documents signed in 1982 and 1983 would be shockingly unjust and inconsistent with all of this Court's relevant precedents, including those cited by Respondents..

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opposed to *remedial* (where the victim is not capable of adjusting the actor's conduct). In the first situation there is reliance on the precedent, in the second, no reliance – at least by the victim.

APPENDIX "A"

LAW OFFICES

BURNHILL, MOREHOUSE, BURFORD, SCHOFIELD & SCHILLER

A PROFESSIONAL CORPORATION

September 6, 1988

Steven Swartz
Business Editor
Wall Street Journal
200 Liberty Street
New York, N.Y. 10281

RE: NASD ARBITRATIONS

Dear Mr. Swartz:

This letter is written with reference to how the National Association of Securities Dealers (NASD) is handling securities cases that are mandated to arbitration after the Supreme Court decision in *Shearson v. McMahon*, 107 Supreme Ct. Rptr. 2332, 96 L.Ed.2d 185. Under the holding of *Shearson*, supra, pre-dispute arbitration agreements are enforceable to compel arbitration of a claim arising under the Exchange Act. I previously worked for the NASD as an arbitration administrator. I was able to observe first hand how the NASD procedures work relative to arbitration claims brought by customers of broker-dealers against member firms.

As an attorney with business and securities experience and academic training as an M.B.A. and C.P.A., I am well able to offer comments on how the arbitration process works at the NASD.

It is stated by Justice Blackmun in his dissenting opinion in the *Shearson* case, that the investor has the impression, frequently justified, that his claims are being judged by a forum composed of individuals sympathetic to the securities industry and not drawn from the public. Further, Justice Blackmun cites Sheldon Elsen, Chairman of the American Bar Association, with the quote that, "The houses basically like the present system because they own the stacked deck."

In my opinion, if a claimant goes before the NASD in seeking recompense for alleged violations by brokers, there is a minimal chance of a fair hearing. In arbitration procedures, there is no right to appeal and there is a bias in the panel selection.

In particular, bias is noted in the panel selections. Panel selections are not carried out in accordance with the guidelines set forth by the Securities and Exchange Commission. In fact, arbitrators who ultimately become panel members, are ranked in a subjective manner based on a numerical rating assigned by the NASD West Coast Head of Arbitrations. If an arbitrator ranks low in the opinion of the Chief of NASD Arbitrations, then that person is not used at all in futur arbitrations. After each arbitration, the arbitrators are again subjectively rated by the NASD Arbitration staff and comments are made in writing to the respective arbitrator's file. Those arbitrators who are deemed less than average, on strictly a subjective basis, are not used again. What the subjective rankings result in is a narrowing of the arbitrators from a large qualified pool to one which is deemed acceptable by standards known only to the NASD. A review of the files

of the NASD would indicate that the arbitrators deemed acceptable are used over and over again.

Further, attorneys who have represented claimants against broker-dealers and who are also qualified as NASD arbitrators, are automatically not selected as arbitrators. The NASD is highly arbitrary in their selection process, leaving little room for a random selection basis as in judge selection, rather than a subjective orientation based on the opinions of the staff of the NASD.

As to the arbitration proceedings themselves, I have sat in on numerous cases and have seen that the arbitrators read very little of the material that complainants or respondents present. The decision making process can be characterized as none other than making snap judgments without weighing detailed factual information of a substantial nature. Discovery is in most cases minimal in nature. There are no written opinions by the arbitrators and no right of appeal. This arbitrary and undocumented process puts the customer at a disadvantage relative to the broker-dealer.

Moreover, arbitrators are typically not knowledgeable in securities law to in effect render a determination as to whether fraud or misrepresentation, have taken place. It should be pointed out that tin a small number of cases, the errors of brokers are so egregious, that fraud or misrepresentation can clearly be identified by the panel members selected.

Brokerage firms can put a lot of pressure on brokers if brokers serving as arbitrators are deciding a number of adverse opinions of large amounts against their own brokerage firms or other firms in the industry. That is, the

arbitration procedures are fraught with conflicts of interest and it is doubtful in my opinion whether the statutory rights of customers can be enforced against broker-dealers in the arbitration forum.

In summary, I find particularly egregious that (1) the arbitrator selection tends to be very haphazard and subjective; (2) the arbitrators do not have sufficient legal background to make the decisions necessary in the vast majority of cases; (3) the forums are rife with conflicts of interest; and (4) the forum itself is biased based on the procedures involved. This letter and any other comments I make can be the subject of a general article relating how the NASD arbitrations work today.

While *Shearson* mandated enforcement of pre-dispute arbitration clauses, it did so with the understanding that the arbitration process was efficient and fair. In practice, the process is far from it. In my opinion, the forum should be modified to use arbitrators who are outside the industry, and in particular, to use lawyers that are independent. Thank you for you time and attention. Please call me if you have any questions relating to this letter. My business telephone number is (415) 937-4950.

Very truly yours,

THOMAS P. HOGAN

TPH:sw